

UPDATE - Taxation of Fixed Indemnity Plans

Issue Date: March 2017

In January, the IRS Office of Chief Counsel issued a memorandum clarifying the tax treatment of certain types of fixed indemnity plans offered by employers. Since the memorandum was released, several fixed indemnity plan insurance carriers have pushed back, stating that the interpretation of the IRS memo was too broad and should not affect the taxation of such plans, but rather was intended to more narrowly address unique wellness plans structured as a type of fixed indemnity plan. Supposedly the IRS plans to release additional clarification on the intent of the memo, but to date we have not seen anything.

Background

Fixed indemnity health plans typically pay a fixed dollar amount for certain health-related events, such as an office visit or the number of days spent in the hospital. They may also include fixed payments when an individual has certain medical conditions. Importantly, the amounts paid are not related to the actual medical expenses incurred by the individual. Employers often offer these types of benefits as supplements to core health insurance benefits. In some cases, employer pay the plan premiums or allow the employee to purchase these benefits on a pre-tax basis through a cafeteria plan.

The memorandum includes two scenarios described as wellness programs. In one example, the “wellness plan” pays cash to participants for specified activities such as completing a health risk assessment. In the other example, employees receive an incentive for simply participating in the program in general. The memorandum clarifies that an incentive or other benefit under a wellness program is excludable from an employee’s income only if it pays for, or reimburses, qualifying medical care, and appears to target programs being marketed as “wellness programs” by some vendors when they are actually a structure allowing the use of tax savings to pay for certain voluntary benefits. Under this guidance, the benefits provided by these programs should be treated as taxable income, making them much less attractive as an option.

When (if ever) Will the Benefit Be Taxable?

This remains an evolving issue...the text of the IRS memorandum clearly states that the benefits provided by a fixed indemnity health plan must be treated as taxable income to an employee if the plan is employer-paid or if the employee can purchase the coverage on a pre-tax basis through a cafeteria plan. However, it is not clear how much employers need to be involved. It would be helpful if the IRS clarified any employer responsibility for reporting the income, and whether the employer has any potential liability for unpaid payroll taxes related to such income.

Clearly, if an employer chooses to offer fixed indemnity plans where employees pay the total premiums on an after-tax basis, there is no issue with taxation no matter what the IRS does going forward. However, if the employer contributes toward the premiums and/or allows any employee contributions to be run through a cafeteria plan on a pre-tax basis, there is likely some tax liability for benefit recipients and potentially some employer responsibility and tax liability as well.

Following statements from multiple fixed indemnity insurance carriers that they have no plans to change their position on the taxation of such plans, and considering the outstanding questions in regard to employer responsibility and tax liability, some employers are choosing to wait and see what, if any, additional guidance the IRS provides.

Potential Employer Action

If the IRS clarifies that there is some employer responsibility and/or tax liability, employers who currently contribute toward fixed indemnity premiums or allow employee contributions for such plans to be handled pre-tax may want to change how premiums are handled going forward. If the employer decides it would prefer to recharacterize pre-tax employee contributions as taxable income, we would suggest that the employer do so by adjusting payroll for the entire calendar year, not just for payments going forward.

On the other hand, if employers would prefer to continue contributing toward such coverage and/or offering the ability to pay for the premiums on a pre-tax basis, it may be necessary to explore options to track benefit payments through fixed indemnity plan vendors going forward, as well as to communicate potential tax liability to benefit recipients. The situation likely creates an administrative problem for the employer since most insurance companies are not currently set up to assist the employer with the taxation of benefits paid to a participant.

Summary

The guidance in the IRS memorandum has no impact on traditional group health insurance plans and does not change the tax treatment of legitimate wellness programs. In addition, there is no tax impact for fixed indemnity plans so long as the employee pays the full premium on an after-tax basis. However, employers who currently offer fixed indemnity-type benefits in a tax-advantaged manner should pay attention as this issue is clarified to ensure the taxation of such benefits is handled appropriately.

The IRS memorandum can be found at <https://www.irs.gov/pub/irs-wd/201703013.pdf>

While every effort has been taken in compiling this information to ensure that its contents are totally accurate, neither the publisher nor the author can accept liability for any inaccuracies or changed circumstances of any information herein or for the consequences of any reliance placed upon it. This publication is distributed on the understanding that the publisher is not engaged in rendering legal, accounting or other professional advice or services. Readers should always seek professional advice before entering into any commitments.